

Audit Report



March 2010

Performance Audit of the City Treasurer's Investments Division

Internal Controls Have
Been Implemented, but
Improvements Can Be
Made in Governance
and Investment Policy
Content

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THE CITY OF SAN DIEGO

March 25, 2010

Honorable Mayor, City Council, and Audit Committee Members
City of San Diego, California

Transmitted herewith is an audit report on the City Treasurer's Investments Division. This report is in accordance with City Charter Section 39.2. The Results in Brief is presented on page 1. The Administration's response to our audit recommendations can be found after page 20 of the report.

If you need any further information please let me know. We would like to thank the City Treasurer's staff, as well as representatives from other City departments for their assistance and cooperation during this audit. All of their valuable time and efforts spent on providing us information is greatly appreciated. The audit staff responsible for this audit report is John Teevan and Kyle Elser.

Respectfully submitted,

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City Auditor

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Results in Brief

The City's cash and investments are significant public assets which require continuous oversight and management. As of June 2009, the City Treasurer is responsible for managing approximately \$2 billion in pooled investment assets. We found that the City Treasurer has internal controls in place to mitigate risks associated with its pooled investment activities. Specifically, we found the controls to be adequate in the following areas:

- The accuracy and completeness of the financial reporting related to City pooled investments;
- Management of City pooled investments, including consistency with the related investment policy and controls related to the transfer of funds and overnight investing;
- Acceptable qualifications of the personnel involved in the investment process; and,
- The adequacy of the request for proposal (RFP) selection process for banking and investment custodian services.

However, during our audit we found that the City Treasurer can strengthen controls associated with the City's Investments Advisory Committee (IAC) and the process of updating changes to the City Treasurer's Investment Policy for Pooled Investment Funds (Investment Policy). By so doing, the City Treasurer can provide greater assurance to the Mayor, City Council, and the Public for the appropriate management of City investment assets.

Within this report we provide three recommendations for the City Treasurer to improve its operations related to governance and updating the investment policy. The Office of the City Treasurer agreed or partially agreed with all of these recommendations. The department's response to our recommendations, and its corrective action plans, are provided at the end of this report.

Background

In accordance with the San Diego City Charter, and under authority originally granted by the City Council in December 1974, the City Treasurer is responsible for investing the unexpended cash in the City Treasury. As provided for by the California Government Code¹ (CGC), the cash balances of substantially all funds and certain outside entities are pooled and invested by the Office of the City Treasurer's Investments Division (Investments Division) for the purpose of increasing interest earnings through investment activities (Pooled Investment Funds). These funds are managed by a Chief Investment Officer and an Investment Officer, with administrative help provided by an Investment Assistant.

The CGC provides the legislative guidance for the general roles, responsibilities and function of the Investments Division, including the creation of an investment policy. The City Treasurer's Investment Policy for Pooled Investment Funds² (Investment Policy), designed in full compliance with the CGC, applies to all investment activities for the City except for the following:

- Employee retirement funds, which are administered separately;
- Proceeds of specific debt issues invested in qualified mutual funds or managed and invested by trustees appointed under indenture agreements; and,
- Trust fund assets placed in the custody of the Funds Commission by Council ordinance.

As noted above, the City currently has a five member Funds Commission which is appointed by the Mayor and confirmed by the City Council. According to the City Charter³, the role of the Funds Commission is to supervise and control all trust, perpetuity, and investment funds of the City and such pension funds as shall be placed in its custody. At this time, the City only has a small number of related permanent endowments which the Funds Commission oversees. Each permanent endowment fund has its own separate investment policy, and, as a result, the allowable investments for these funds can be different from those approved in the City Treasurer's Investment Policy.

The City also has funds invested in accordance with bond indenture and trustee agreements. The investment of these funds is governed by the policies set forth within individual indenture and trustee agreements, and the Investments Division executes transactions for these trustee-held bond funds.

The City's Investment Policy

The City Council annually approves the City Treasurer's Investment Policy and the CGC allows the City Council to delegate responsibility to the City Treasurer to invest City funds, or to sell or exchange securities.

¹ CGC sections 53600 through 53610, available at http://www.leginfo.ca.gov/html/gov_table_of_contents.html.

² Available at <http://www.sandiego.gov/treasurer/investments/invpolicy.shtml>, most recently adopted in November 2009 by the San Diego City Council.

³ City Charter Article V, Section 41(a).

The objectives of the City's Investment Policy are the following:

1. *Safety of Principal*: investment decisions are made to minimize net capital losses on a portfolio basis, with the policy designed to ensure that losses are minimized on a portfolio level rather than with each individual transaction. The City's goal is to preserve principal by mitigating various types of risk, including credit and market risk.
 - a. Credit risk shall be mitigated by investing in only very safe securities, as described separately, and by diversifying the investment portfolio so that the failure of any one issuer would not unduly harm the City's cash flow.
 - b. Market risk is mitigated by the establishment of two portfolios, called the Core and Liquidity Portfolios, with target durations based upon the expected long- and short-term cash needs of the City. The Core Portfolio consists of high quality liquid securities with a maximum maturity of five years. The Core Portfolio is structured to meet the longer-term cash needs of the City and match or exceed the performance of the benchmark index. The Liquidity Portfolio is structured with an adequate mix of highly liquid securities and maturities to meet major cash outflow needs for at least the next six months, in compliance with the CGC, approximating the duration of the benchmark index.
2. *Liquidity*: while both portfolios invest in liquid securities and emphasize the safety of principal, the Liquidity portfolio is structured to ensure that six months of City expenditure requirements can be met with expected revenues and a combination of maturing securities, coupon payments and / or highly liquid investments.
3. *Performance Measurement*: the portfolios are designed to attain a market average rate of return through economic cycles.

Per the City's Investment Policy, the City Treasurer is required to submit a quarterly investment activity report to the City Council in accordance with the CGC. The City Treasurer has elected to provide a monthly report consistent with the CGC reporting requirements. These reports are available on the Investments Division's public website⁴.

The following general limitations and restrictions are noted within the Investment Policy in relation to investment transactions:

- Trading is prohibited when cash or liquid securities are not available to purchase securities;
- Selling securities the City does not own, commonly referred to as "taking short positions" is prohibited;
- The City does not currently engage in any securities lending activities;
- Investments exceeding five years in maturity require City Council approval, no less than three months prior to the date of purchase;
- Certain types of security purchases are specifically prohibited⁵;
- Callable securities, which are securities redeemable in part or in full by the issuer prior to the maturity date, shall not exceed 30 percent of the cost value of the portfolio.

⁴ Available at <http://www.sandiego.gov/treasurer/investments/reports.shtml>.

⁵ Including: a security that could result in a zero interest accrual if held to maturity, inverse floaters, range noted and interest only strips that are derived from a pool of mortgages.

The City's Investment Policy details authorized investments, including general dollar and maturity limitations (if any). The Appendix documents the quarterly schedule prepared by the Investments Division indicating compliance of the investment portfolio with the Investment Policy for each type of investment as of June 30, 2009. In general, the following were noted with regard to investment limitations:

- U.S. Treasury bills, bonds and notes have no limitations;
- U.S. government agencies are restricted to 33.3 percent of the portfolio per issuer;
- The remaining allowed investments may have individual specific percentage limits, restrictions based on ratings from Nationally Recognized Statistical-Rating Organizations such as Moody's, Fitch and Standard & Poor's, and other investment-specific limitations.

Common stocks and long-term corporate notes and bonds with a maturity greater than five years are prohibited from the portfolios per the Investment Policy. The Investment Policy also requires an annual independent audit conducted by a public accounting firm, which includes a review of the investment procedures and activities of the Investments Division. This requirement is currently being fulfilled by the firm of Macias Gini & O'Connell LLP, as part of the overall audit of the City's Comprehensive Annual Financial Report (CAFR)⁶.

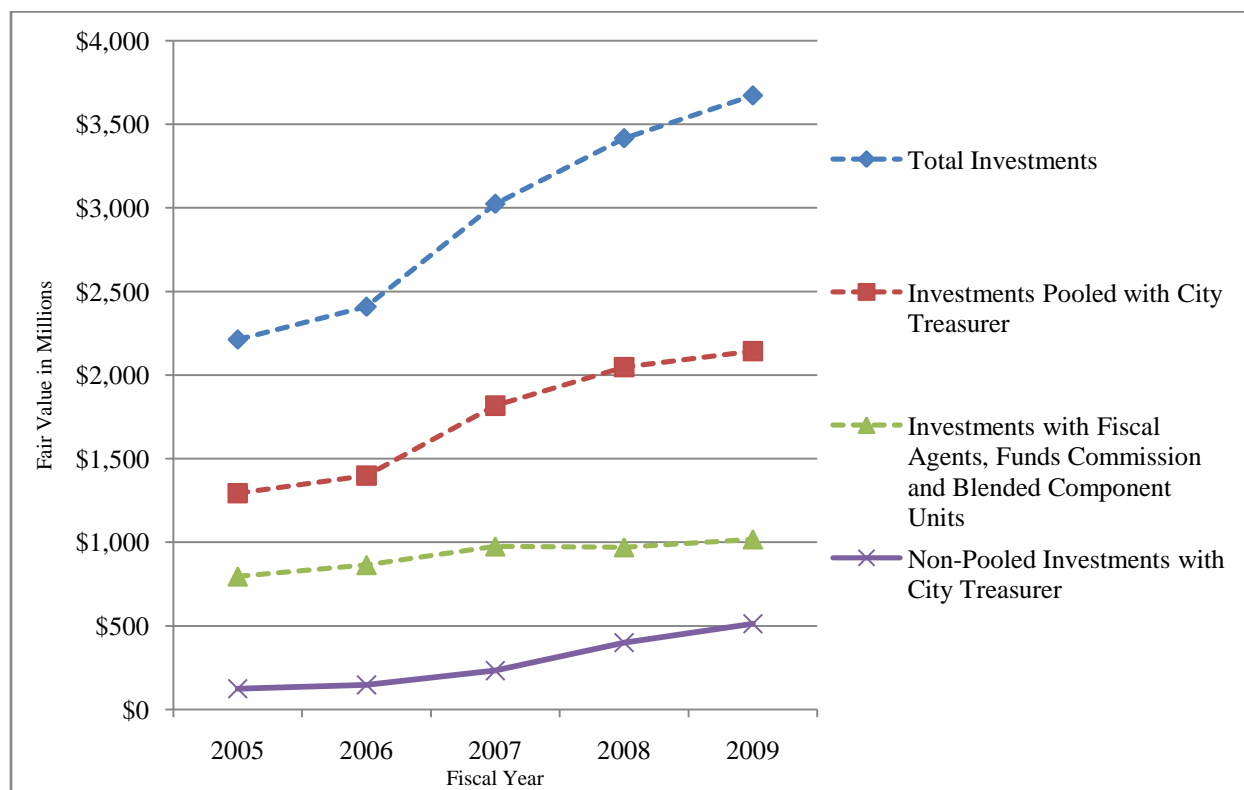
In June 2007, the City received the Investment Policy Certificate of Excellence Award from the Association of Public Treasurers of the United States and Canada (APT US&C), which helps assure the City and the public that the City's Investment Policy is abiding by professional standards established to ensure prudent management of public funds. APT US&C recommends having an investment policy recertified by the organization every three years.

⁶ Reports available at <http://www.sandiego.gov/comptroller/reports/index.shtml>.

The following amounts in Figure 1 represent summarized historical balances of the City's significant treasury investments from fiscal years ended June 30, 2005 through 2009:

Figure 1

The Value of Treasury Investments Have Significantly Increased Between Fiscal Years 2005 and 2009



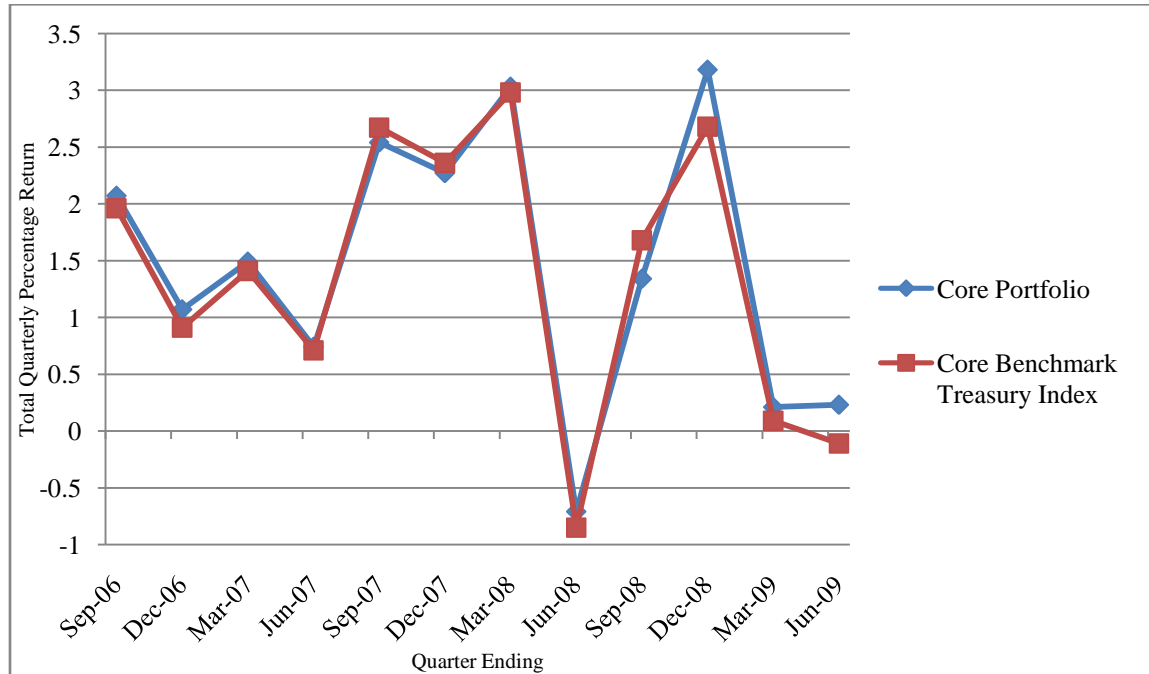
Source: Auditor generated from City of San Diego Comprehensive Annual Financial Report Data from fiscal years ended June 30, 2005 through 2009

The Investments Division of the City Treasurer's Office is directly responsible for the management of the pooled investments governed by the Investment Policy. As of June 30, 2009, the total assets managed directly by the Investments Division in the Pooled Investment Fund totaled approximately \$2.1 billion. The investments are composed of two portfolios: Core and Liquidity. The Core portfolio is longer-term, with investment maturities up to five years, and is managed on a total-return basis versus the Merrill Lynch 1-3 Year Treasury Index⁷, as graphically displayed in Figure 2 below. By comparison, the Liquidity portfolio is short-term in nature, with investment maturities of less than a year, and is managed on an earned income yield basis versus the Merrill Lynch 3-6 month Treasury Index over a rolling three year period.

⁷ The Merrill Lynch Treasury Indices are unmanaged market indices consisting of all public U.S. Treasury obligations having maturities within specified ranges (i.e. 1-3 years). It is not possible to invest directly in an unmanaged index.

Figure 2

Core Investment Portfolio Returns Have Been Generally Consistent with Its Benchmark Index Between Fiscal Years 2007 and 2009



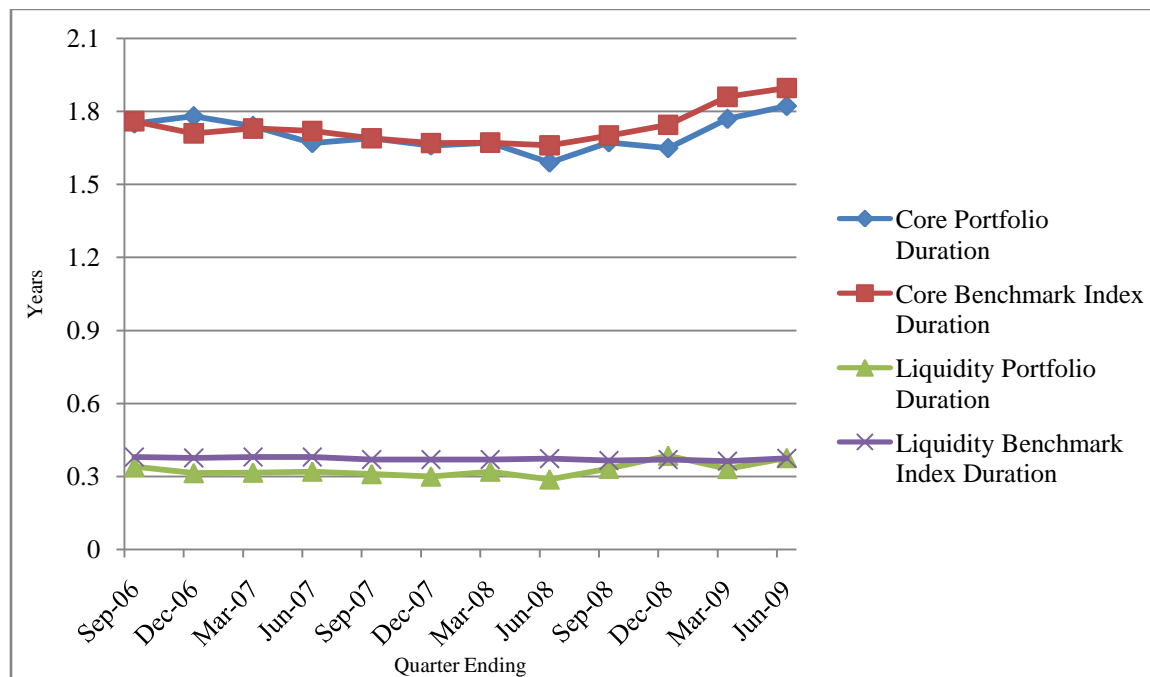
Note: For the fourth quarter of fiscal year 2009, the Core Portfolio outperformed the benchmark treasury index by 34 basis points (or 0.34%).

Source: Auditor generated from City of San Diego Pooled Investment Fund Quarterly Review Data

The calculated durations⁸ of the Core and Liquidity portfolios of the Pooled Investment Funds are also reviewed for consistency with the durations of the Merrill Lynch 1-3 year and 3-6 month Treasury Indices, respectively. These comparative durations have been graphically illustrated in Figure 3 below:

Figure 3

Investment Durations for the Liquidity and Core Portfolios Have Been Generally Consistent with Benchmark Indices Between Fiscal Years 2007 and 2009



Source: Auditor generated from City of San Diego Pooled Investment Fund Quarterly Review Data

⁸ The duration of a financial asset, typically a bond, is a measurement of the sensitivity of an asset's price to interest rate movements, and broadly corresponds to the length of time before the asset is due to be repaid.

Overnight Repurchase Agreements

To maximize earnings on the City's unexpended overnight cash while maintaining maximum flexibility in accounting for daily inflows and outflows, the Investments Division typically enters into a repurchase agreement⁹ with an eligible broker or dealer each business day. During fiscal years 2007 through 2009, these agreements netted approximately \$4.2 million in investment income for the City.

The City Treasurer's Investment Advisory Committee

According to the Chief Investment Officer, the Investment Advisory Committee (IAC) is responsible for reviewing on an on-going basis the Investment Policy and practices of the Investments Division and to recommend any changes. The IAC is not a creation of the City Council or other municipal law, instead was created by a prior City Treasurer with the intent of formalizing a secondary review and ongoing discussion about the investment process and reports to help further strengthen the credibility and oversight of the City Treasurer's Pooled Investment Fund. Potential members must complete an IAC "Appointment Application" form to be considered, and must have experience managing money with full discretionary power.

The IAC consists of five members, including two City staff and three public members. The two City staff are currently the City's Chief Financial Officer and the Director of Debt Management. The IAC typically meets two times per year, with regular participation and contributions from the public members as well as the City staff. The two current public members are both financial experts specializing in institutional investors. Both have extensive government-related investment experience, with one member previously being Investment Officer for the County and then City of San Diego (between 1975 and 1985) and the other being appointed in 2000 to the Investment Advisory Committee of the California Debt and Investment Advisory Commission (CDIAC). Both are currently the founder and president of separate private investment consulting firms. According to Investments Division staff, the third public member recently resigned from the IAC, leaving one position vacant as of Fall 2009.

In addition to the monthly investment activity reports, the Investments Division prepares a quarterly report for review by the IAC and distribution to the City Council and City management. The quarterly report provides a comprehensive analysis of the performance of the City's Pooled Investment Fund, its current state, expected future direction, and compliance with the Investment Policy. Currently, the quarterly report includes the following sections (and related page numbers):

1. Economic Commentary (page 1 to 2);
2. Key Economic Indicators (page 2);
3. Portfolio Performance and Returns (page 3);
4. Portfolio Profile (page 4);
5. Portfolio Strategy (page 5);
6. Projected Portfolio Cash Flows (page 5);
7. Portfolio Compliance with the Investment Policy (page 6); and,
8. Portfolio Holdings (pages 7 to 9).

⁹ A repurchase agreement is a form of short-term borrowing for dealers in government securities. The dealer sells the government securities to investors, usually on an overnight basis, and buys them back the following day.

Investments Division Procedures Manual

The Investments Division has documented a detailed procedures manual, which includes the following topic specific sections and detailed procedures:

1. *Daily Investment Activity*: includes the daily investment and cash worksheet process, investment assistant morning duties and daily investment worksheet;
2. *Periodic Reporting*: includes the monthly reconciliation of investment accounts and reporting, creation of the quarterly portfolio review and weekly reconciliation of custodial bank assets;
3. *Payments*: includes tax payments, payroll and pension processing, non-recurring wire payments and wire template setup;
4. *Investment Related*: includes repurchase agreement and collateral pricing, month end rebalancing, transferring securities between portfolios and security trading for both City managed and trustee held funds.

Objectives, Scope, and Methodology

The City Auditor's Fiscal Year 2009 and 2010 Audit Work Plans approved by the City Council included a performance audit of the Office of the City Treasurer's Investments Division (Investments Division). The main objective of the audit is to determine if investments are being properly handled, accounted for and accurately reported in the City's financial statements. Upon initial analysis of information gathered during the scoping phase of our audit, we decided to focus our audit efforts on six risk areas that the City faces related to investments activity:

1. The adequacy of the Investment Policy as well as whether the pooled investments are aligned with the City's Investment Policy (Investment Policy) and fiscal strategies of the City.
2. The accuracy and completeness of financial reporting related to City pooled investments.
3. The existence and adequacy of internal controls related to the management of City pooled investments, management consistency with the Investment Policy, transfers of funds, and overnight investing.
4. Appropriate qualifications of personnel involved in the investment process.
5. The adequacy of the Request for Proposal (RFP) selection process for banking and investment custodian services.
6. The adequacy and effectiveness of the oversight related to pooled investments by City management and the Investment Advisory Committee.

To accomplish our objectives we performed the following audit procedures:

- Reviewed pertinent laws, policies and regulations related to investments;
- Gathered and analyzed information related to the City's pooled investments;
- Identified, collected, and analyzed financial information and management reports related to the City's pooled investments;
- Evaluated current City processes for pooled investments;
- Interviewed management and key staff in charge of managing and monitoring information related to pooled investments;
- Analyzed the quality and effectiveness of pooled investment-related reporting.

We limited the scope of our review to investments from fiscal years 2007 through 2009, unless noted otherwise.

We evaluated the internal controls related to our audit objectives. Our conclusions on the effectiveness of these controls are detailed within the following audit results.

We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Audit Results

The City's cash and investments are significant public assets which require continuous oversight and management. During the course of our audit, we noted that the City Treasurer routinely prepares both monthly and quarterly investment reporting on a timely basis for distribution to the Mayor, City Council, City management and other oversight entities such as the City's Investments Advisory Committee (IAC). We also observed that the Office of the City Treasurer's Investments Division (Investments Division) has developed and implemented detailed internal controls to mitigate the risks associated with the City's pooled investments. In addition, Investments Division personnel are well qualified in their roles to continue to support the investment objectives of the City. Moreover, our review of the selection process used for the banking and investment custodian services (currently Bank of America and Bank of New York Mellon, respectively) appeared adequate.

However, during our audit we found that the IAC does not have a formalized charter or similar document to identify its roles and responsibilities. Without such written documentation for these processes it is difficult for the IAC to ensure that their oversight is efficient and effective. Furthermore, some consensus recommendations have not been formally incorporated into the Investment Policy for the City's Pooled Investment Funds (Investment Policy) or comparable governance documentation. In addition, we found that the Investments Division did not properly incorporate certain approved changes into the Investments Policy between the 2006 and 2007 annual update and approval process. Furthermore, the Investments Division does not retain a complete record of the supporting documentation for annual Investment Policy updates. Without adequate documentation and the inclusion of Investment Policy changes between update cycles, oversight controls over Investment Policy updates could be ineffective.

Internal Controls and Investment-Related Reporting Processes Are Documented and Implemented

The Investments Division maintains significant accounts for all internally managed investments, including the City's Pooled Investment Funds and other funds created to accommodate special needs and reinvestment of proceeds from bond issues. Two Investments Division staff are responsible for directly managing in excess of \$2 billion in pooled investments with the support of an Investment Assistant, and indirectly involved with the management of other City investments, while performing appropriate cash flow management for the City. As a result, formalized and implemented internal controls, including performance reporting, are important to the Investments Division's success and sustainability.

The City Treasurer routinely distributes monthly investment reports on a timely basis consistent with the requirements of the Investment Policy. The Investments Division also prepares a more detailed quarterly investments performance review report for additional disclosure and subsequent distribution to the IAC, City Council and City management. The monthly reports include detailed and summarized investment assets, while the quarterly reports provide a more comprehensive review of the City's investment performance, its current and expected future

direction and compliance with the Investment Policy. These two types of informational reports are available on the Investments Division's public website¹⁰.

The Investments Division has also developed and implemented detailed internal controls. These internal controls have been documented in a comprehensive procedures manual compiled by the Investments Division. Moreover, in our opinion, key Investments Division staff are appropriately qualified in their roles to continue supporting the investment objectives of the City. The Chief Investment Officer has been with the Investments Division for almost ten years, has a graduate degree with a finance emphasis, has been a Certified Cash Manager since 2002, has passed the first two levels of the Chartered Financial Analyst (CFA) exam and will be taking the Level 3 exam in June 2010 and has spoken at several conferences and universities about investments and cash management topics. The Investment Officer has been with the Investments Division for almost three years, has approximately 12 years of prior investment-related experience, has an undergraduate degree in finance and accounting, and is an active CFA charterholder. Both regularly attend investment-related conferences and seminars.

Furthermore, the selection process for the City's banking and investment custodian services are adequate. Upon the final recommendations of the Banking and Custodial Services Request for Proposal Selection Committees, City management negotiated and executed agreements with Bank of America for banking services, and the Bank of New York Mellon for investment custodian services. These agreements were executed in December 2007 and February 2009 for terms of five and four years, respectively.

¹⁰ Available at <http://www.sandiego.gov/treasurer/investments/reports.shtml> .

Investment Advisory Committee Roles and Responsibilities are Not Formally Defined

During our audit we found that the roles and responsibilities of the City's Investment Advisory Committee (IAC) have not been defined. The *Local Agency Investment Guidelines*¹¹ (Guidelines) of the California Debt and Investment Advisory Commission (CDIAC) provide valuable guidance related to the oversight of a county treasury's oversight committee. A review of this information revealed that roles, responsibilities and related administrative processes for the IAC have not been formally developed and implemented. The incorporation of these best practices within formalized policies and procedures for the IAC could further ensure adequate and consistent oversight.

The Guidelines were developed by a working group of the CDIAC¹² following the 1994 Orange County investment pool bankruptcy intended to aid local officials in their efforts to implement the resulting new laws. CDIAC updates these Guidelines annually to include legislative changes, and these Guidelines include best practice "consensus recommendations" which were updated in December 2006. Of note, the 2006 working group included one of the current public members of the IAC.¹³

The Guidelines include a chapter identifying "consensus recommendations" for treasury oversight committees, which are governed by law for county agencies, but could still be reviewed by the IAC for incorporation. This chapter contains options available for structuring a treasury oversight committee, whether the appointment of the treasurer to the treasury oversight committee can create a conflict of interest, the role of the treasury oversight committees, and whether other local agencies (i.e. cities) should have treasury oversight committees. In relation to the role of a county's treasury oversight committee, the following guidance is provided within the Guidelines:

"Considerations by the committee regarding the risk and structure of a portfolio are permitted in the law; however, any attempts to direct individual investment decisions, select individual investment advisors, brokers, or dealers, or impinge on the day-to-day operations of the county treasurer are discouraged. The local agency should clearly stipulate that the responsibilities of the treasury oversight committee are to focus on investment policy issues and to audit the portfolio for compliance with the policy. The oversight committee should not impinge on the day-to-day operations of the county treasurer."

Although not required by law, the City does have an active investment advisory committee in which the City Treasurer does participate as a non-appointed member. However, the IAC has not formally adopted or implemented an official committee charter or similar documentation defining its roles and responsibilities and any related administrative processes. Furthermore, only

¹¹ Available at http://www.treasurer.ca.gov/cdiac/publications/alphabetical.asp#local_guide

¹² Subsequently renamed from the California Debt Advisory Commission based on statutory changes after 1996, including the addition of providing investment education and research to their statutes.

¹³ Per the Guidelines, "the 'consensus recommendations' included in the Guidelines had not been updated since 1996 to address changes in statute or practices reflective of the current public fund investment environment. In December 2006, CDIAC convened another working group of public-and private-sector public finance industry professionals to revise and update the consensus recommendations. All participants of the working group agreed with or had no strong objections to the consensus recommendations found in the Guidelines."

limited information specifically on the IAC and its roles and responsibilities is included on the Investments Division's public website. Formally developed and implemented roles and responsibilities for oversight committees are valuable to that committee's efficiency, effectiveness, and the ongoing recruitment and retention of its membership.

By not having a controlling document such as a charter for the IAC, the recommendations or other guidance provided to the Investments Division may not be ensured of adequate consideration or implementation without an adequately documented follow-up process. The IAC may also attempt to apply inappropriate influence on related processes or decisions without defined limitations.

Investment Policy is not Consistent with Consensus Recommendations

During our audit we found that certain best practices are not included in the City's Investment Policy. A review of the current Investment Policy, last updated in November 2009, revealed that some consensus recommendations from the 2008 *Local Agency Investment Guidelines* (Guidelines) of the California Debt and Investment Advisory Commission (CDIAC) have not been incorporated. Although not required for municipal treasurers within California, an analysis of this information shows that the incorporation of these consensus recommendations could improve the quality of oversight or business decisions by the IAC or City management.

A good investment policy serves as a guide for setting and achieving program objectives, defines rules and establishes benchmarks, and reduces the exposure to liability of both the investment staff and the governing body. The Investment Policy was developed to effectively administer and manage the general investment activities of the City¹⁴. The Investment Policy includes the City's investment objectives, reporting obligations, types of permitted investments, risk exposure thresholds, required investment ratings, as well as other internal control-related requirements and expectations. Investments Division staff update the Investment Policy on an annual basis, however, these updates have not included certain items identified as best practices.

We noted that the following, although not required for county or municipal treasurers in California, have not been specifically included in the City's Investment Policy as referenced as consensus recommendations in the Guidelines:

- The inclusion of the rating of the security, purchase date and comparative performance measures or benchmarks within the reporting to the City Council¹⁵;
- For medium-term notes, including reference to the stipulation that the corporation be organized within the United States in the Investment Policy;

Furthermore, although required for California county treasurers but not municipal treasurers, we also noted that the following consensus recommendations have not been included in the City's Investment Policy:

- A requirement that the treasurer provide the oversight committee (i.e. the IAC) with investment reporting as required for the City Council¹⁶;
- Limits on the receipt of honoraria, gifts, and gratuities for oversight committee (i.e. the IAC) members from advisors, brokers, dealers, bankers, or other persons with whom the treasury conducts business.

The incorporation of these items from the Investment Policy could improve the quality of oversight and management decision-making, and further ensure that investments or investment-related transactions are appropriate.

¹⁴ Does not include employee retirement funds, which are administered separately, the proceeds of certain debt issues which are invested in qualified mutual funds or managed and invested by trustees appointed under indenture agreements, and the assets of trust funds which are placed in the custody of the Funds Commission by City Council ordinance.

¹⁵ The ratings and comparative performance measures or benchmarks are reported in aggregate for the overall Pooled Investment Fund in the quarterly reporting distributed by the City Treasurer.

¹⁶ The Quarterly Portfolio Review and monthly reports are sent out by the City Treasurer to the members of the Investment Advisory Committee on a periodic basis.

City Council Accepted Investment Policy Not Used in Subsequent Year's Update

The Investments Division did not properly incorporate some changes to the Investment Policy in November 2006, as accepted by the City Council at that time, into the version used in preparing the update for 2007. An analysis of these documents shows that certain 2006 updates have not been incorporated into the version approved the following year. Furthermore, a complete documentation record is not maintained of the various sources of information utilized in the annual updates. The usage of an incorrect version of an official policy or the absence of supporting documentation could result in errors, omissions or overall process inefficiencies in subsequent updates by City management and approval by the City Council.

Proper subsequent use of authorized policies by legislative bodies such as the City Council, as well as making the optimal utilization of limited oversight resources, is important to the efficiency and effectiveness of the oversight process. The utilization of government resources, both financial and physical, as well as informational resources, to effectively, efficiently, economically, ethically, and equitably achieve the purposes for which the resources were furnished or the program was established is a fundamental responsibility of management.¹⁷ As noted previously, the Investment Policy was developed to administer and manage the general investment activities of the City. The Investment Policy is updated annually, typically in the month of November each year, using the prior approved Investment Policy as the seminal version.

Although they do not appear to be significant, we noted that certain types of changes¹⁸ accepted by the City Council in 2006 were not carried forward to the version subsequently initially used in preparation for the November 2007 policy update. Per discussion with Investments Division staff, this inconsistency occurred in part due to successive turnover with the division's Chief Investment Officer position. In addition, the Investments Division does not retain a comprehensive documentation record of sources utilized in the processing of annual updates, such as other local government investment policies or information obtained from discussions with outside entities.

¹⁷ Paragraph A1.08, Government Auditing Standards, July 2007, available at <http://www.gao.gov/new.items/d07731g.pdf>

¹⁸ Primarily representing language clarification or consistency changes, as well as several new sentences or sentence fragments.

Conclusion

The City's cash and investments are an integral component to the ongoing financial stability of the City of San Diego (City). As a result of the inherent nature of these financial assets, effective management of City investments requires continuous quality management and administration. The performance of the City's investments is considered to be consistent with policy objectives. With recent extreme economic instability and uncertainty, it is critical for the City to ensure that the limited resources available for cash and investments-related activities are used in the most effective and efficient manner.

We noted that the City's Investments Advisory Committee (IAC) does not have a formalized charter or similar to identify its roles and responsibilities, and some best practices have not been formally incorporated into the Investment Policy for the City's Pooled Investment Funds (Investment Policy). Furthermore, we also noted that the Office of the City Treasurer's Investments Division (Investments Division) did not properly incorporate certain changes to the Investment Policy in November 2006 as accepted by the City Council in the following year.

Based on the findings of our audit we recommend that a charter or comparable document for the Investment Advisory Committee be developed defining the roles, responsibilities and related administrative processes for the committee. The City Treasurer should also review the Investment Policy for the effective inclusion of identified, but currently unincorporated, best practices within the subsequent update to the Investment Policy and in the finalized Investment Advisory Committee charter (or comparable controlling document). A written procedure for a complete and accurate annual update of the Investment Policy should be developed to ensure proper handling and processing by Investments Division staff. By making these changes, the City could improve its oversight and efficiency in managing these investment functions.

Recommendations

To improve the efficiency of the IAC and recommendations made by the IAC, the Investments Division should take the following action:

1. The City Treasurer should finalize and implement a charter or comparable controlling document for the Investment Advisory Committee defining the roles, responsibilities, term limits, applicant requirements and related administrative processes for the committee. This document, and related committee reference information, should be included and maintained on the Investments Division's public website.

To improve the quality of information used in the management of City investments, the Investments Division should take the following action:

2. The City Treasurer should review and update the Investment Policy for inclusion of the identified consensus recommendations during the subsequent update to the Investment Policy, within an official Investment Advisory Committee charter or comparable controlling document, as appropriate.

To maintain the quality of the investment policy which guides the management of City investments, the Investments Division should take the following action:

3. The City Treasurer should formally document a written procedure for processing complete and accurate annual updates for the Investment Policy, including the critical steps in the process from initiation to acceptance by City Council and subsequent handling in preparation for the following year. This procedure should be crafted to effectively and efficiently update the policy, but also provide for appropriate record management clearly identifying documentation requirements during various stages of the process.

Appendix

Portfolio Compliance with the City's Investment Policy

Portfolio Compliance with Investment Policy

The City of San Diego Pooled Investment Fund is in full compliance with the City Treasurer's Investment Policy, which is more restrictive than the California Government Code. The Investment Policy is reviewed annually by the City's Investment Advisory Committee and approved by the City Council.

Category	Standard	Comment
Duration (Core)	ML 1-3 Year +/-20%	Complies – 93.42 %
Duration (Liquidity)	US T-bill 3-6 months +/-40%	Complies - 90.91 %
Maximum Maturity	5 years	Complies
Agency Securities	100% maximum	Complies – 33.56%
FNMA	33.3% maximum	Complies– 7.57%
FHLMC	33.3% maximum	Complies – 9.15%
FHLB	33.3% maximum	Complies – 13.61%
FFCB	33.3% maximum	Complies – 3.23%
Callable Securities	30% maximum	Complies – 10.51%
MBS/CMO's	5 yr maximum- 20% max.	Complies – None in Portfolio
Asset-backed	5 yr maximum- 20% max.	Complies – None in Portfolio
Commercial Paper	A1/P1- 5% per issuer	Complies
	25% maximum	Complies – 2.22%
Banker's Acceptances	A1/P1- 5% per issuer	Complies – None in Portfolio
	40% maximum	Complies – None in Portfolio
Medium Term Notes (includes Bank Notes)	'A' Rating' by at least two agencies	Complies
	3 year maximum	Complies
	30% maximum	Complies – 8.12%
Mutual Funds	20% maximum	Complies – 5.19%
FDIC-insured Certificates of Deposit	1% maximum	Complies – 0.74%
Certificate and Public Deposits	30% maximum	Complies – None in Portfolio
Reverse Repos	20% maximum	Complies – None in Portfolio
Futures and Options	Prohibited	Complies – None in Portfolio
Custody	Bank trust dept.	Complies – Bank of NY
Exposure per issuer (corporate)	5% of total portfolio	Complies
Structured Notes	8% maximum/no multiple index structures.	Complies - 3.21%
Municipal Securities	'A' Issuer Rating by an NRSRO	Complies – None in Portfolio
	20% maximum	Complies – None in Portfolio
	5% of total portfolio exposure per Issuer or Insurer, excluding California Gen- eral Obligations	Complies – None in Portfolio



THE CITY OF SAN DIEGO

M E M O R A N D U M

DATE: March 23, 2010

TO: Eduardo Luna, City Auditor

FROM: Gail R. Granewich, City Treasurer
Mary Lewis, Chief Financial Officer

Gail R. Granewich
Mary Lewis

SUBJECT: Response to Draft *City Treasurer Investments Division* Audit Report

This memorandum is in response to the City Auditor's January 2010 *City Treasurer Investments Division Audit Report (Audit Report)*. As stated therein, the City's cash and investments are significant public assets which require continuous oversight and management. The City Treasurer's Investments Division oversees approximately \$2.4 billion in assets, as of June 30, 2009, and received a Certificate of Excellence Award from the Association of Public Treasurers of the United States and Canada for the City Treasurer's Investment Policy.

Given the relative importance of this audit, the City Council and the citizens of San Diego should note that the City Auditor found no significant findings and concluded that the City Treasurer has internal controls in place to mitigate risks associated with its pooled investment activities. The lack of any significant findings within the Audit Report demonstrates the hard work and diligence taken by the Investments team in managing and safeguarding the City's investments.

Although the Audit Report was favorable overall, it omitted some of the significant achievements of the Investments Division. For example, over the ten-year period ending June 30, 2009, the Core portfolio outperformed its benchmark by an annualized 35 basis points per year on a total return basis (interest received plus market price change). This outperformance equates to approximately \$3.1 million per year based on an average investment balance of the fund for the 10 year period. Additionally, the Liquidity portfolio exceeded its benchmark by 19 basis points for the same timeframe, resulting in additional income to the City of nearly \$1 million per year. Finally, the prudent investment strategy of Department staff resulted in the City's Investment Pool experiencing no defaults during several corporate scandals and the most recent financial crisis.

While we agree with two of the three findings in the Audit Report, the Report's application of CDIAC's "Consensus Recommendations" is misplaced. The Audit Report compares municipal

investment pools to County pools. Due to the very different scope, reporting obligations (that is, multiple public agencies for a County pool) and oversight responsibilities of County pools, the report engages in an “apples to oranges” comparison that is not meaningful to the City.

The following specific responses are provided to the *City Treasurer Investments Division Audit Report*:

Recommendation 1: *The City Treasurer should finalize and implement a charter or comparable controlling document for the Investment Advisory Committee defining the roles, responsibilities, term limits, applicant requirements and related administrative processes for the committee. This document and related committee reference information should be included and maintained on the Investments Division’s public website.*

Response: Agree with recommendation. Draft Bylaws were presented to the Investment Advisory Committee (IAC) at the October 2009 meeting. It is expected that the revised Bylaws will be approved and adopted by the IAC at the April 2010 meeting. Once the Bylaws have been approved, they will be added to the Office of the City Treasurer Investments Division website to further our practice of providing full disclosure to the public.

Recommendation 2: *The City Treasurer should review and update the Investment Policy for inclusion of the identified consensus recommendations during the subsequent update to the Investment Policy within an official Investment Advisory Committee charter or comparable controlling document, as appropriate.*

Response: Partially agree with recommendation. The Investment Policy is considered a “living document” and is reviewed throughout the year for changes that may result from State legislative activities and market conditions. The inclusion of “Consensus Recommendations” which are primarily focused on County investment pools may be inappropriate for the City’s investment pool since County pools are run differently and must adhere to stricter reporting guidelines. This is due to the fact that County pools also manage investments for outside entities, such as school districts and other municipalities, while the City’s investment pool does not allow for investment by parties external to the City.

Most of the recommendations regarding the Investment Policy are incorporated, or will be incorporated, within the City Treasurer’s Investment Policy and/or the Monthly and Quarterly Investment Reports by the end of this calendar year. For instance, the distribution of security ratings and fund performance are both reported in the Investments Division Quarterly Report distributed to the Mayor, City Council, Independent Budget Analyst, City management and the IAC and available on the City Treasurer’s website. The recommendation to include limits on receipt of honoraria, gifts and gratuities, as well as formalizing distribution of investment reports to the IAC, have been addressed in the IAC proposed Bylaws currently pending approval by the Committee.

As mentioned in the Audit Report, the City's Treasurer's Investment Policy received a Certification of Excellence Award by the Association of Public Treasurers of the United States and Canada during its last review cycle in 2007. The City Treasurer's Investment Policy is more restrictive than California Government Code and, as determined by the oversight of the IAC, is sufficient in its current form to ensure outstanding internal controls and provide for prudent management of the City's investment pool. The Office of the City Treasurer's Investments Division is also one of the few California municipalities that distributes both a Monthly and Quarterly report in an effort to increase investments disclosure to the public and outside entities.

Recommendation 3: *The City Treasurer should formally document a written procedure for processing complete and accurate annual updates for the Investment Policy, including the critical steps in the process from initiation to acceptance by City Council and subsequent handling in preparation for the following year. This procedure should be crafted to effectively and efficiently update the policy, but also provide for appropriate record management clearly identifying documentation requirements during various stages of the process.*

Response: Agree with recommendation. Procedures have been put into place to ensure complete and accurate annual updates of the Investment Policy. The clerical oversight that occurred in finalizing the November 2007 Investment Policy was unintentional and had no significant impact. Although not mentioned in the Audit Report, the Investments Division reengineered their procedures for updating the City Treasurer's Investment Policy in early 2008. These changes have significantly strengthened the annual review and updating process.

cc: Honorable Mayor Jerry Sanders
Honorable City Council Members
Jay M. Goldstone, Chief Operating Officer
Andrea Tevlin, Independent Budget Analyst
Jan Goldsmith, City Attorney
Kent Morris, Chief Investment Officer
Kyle Elser, Audit Manager